Testimony of Professor Jeffrey O'Connell, University of Virginia Law Professor, before the Health Subcommittee of the U. S. House Energy and Commerce Committee, July 13, 2006.

Summary

In the May 11, 2006 issue of the New England Journal of Medicine authors David Studdert and Michelle Mello and their colleagues reported on a closed claims study of medical malpractice claims. The study found that the system takes far too long - on average five years from the occurrence. The study also found that it chews up far too much in overhead costs, principally legal fees on both sides, amounting to more than half (54%) of any compensation paid. In the words of the study, "substantial savings depend on reforms that improve the system's efficiency in the handling of reasonable claims for compensation."

It is just such a change that my testimony proposes:

Under the early offer bill, liability insurers for health care providers have the option within 180 days after a claim is filed of making an offer, binding on claimants, to effect periodic payment equal of claimant's net economic loss (i.e., beyond any other insurance), plus reasonable legal fees, but nothing for pain and suffering. If the claimant does not accept this offer, the claimant can proceed with a normal tort claim for both economic and noneconomic damages, but the legal standards of both the burden of proof and level of misconduct applied to the claim would be raised, with the claimant having to prove the defendant grossly negligent beyond a reasonable doubt. If the defense does not make an offer, the current system applies.

Testimony

Insurers would decide whether to make the early offer described in the Summary above by comparing the cost of the early offer to their expected cost under normal tort rules assuming the claim is not settled under the early offer proposal. This expected cost would equal the net economic damages (medical expense and wage loss but, as stated, not pain and suffering) plus an allowable payment of the claimant's lawyers, which is presumed to be 10 percent of the value of the early offer. That is, the insurer will make an offer when the expected liability and litigation costs if the claim is not settled under the early offer proposal are greater than the net economic damages and the allowable claimant's legal fees.

Thus, the insurer will make an early offer when the amount of the early offer is less than the insurer's expected exposure from a full-scale tort claim.

Numbered items i and ii below present some of the main criticisms of current medical malpractice law.[1] Numbered items iii-xi below relate the early offer proposal to the medical

[1] The following numbered items i-ix are adapted from Jeffrey O=Connell, *Statutory Authorization of Nonpayment of Non-economic Damages*, 71 Tenn. L. Rev. 191-95 (2003). For a brief presentation of the inadequacies of current medical malpractice law, see Jeffrey O=Connell & Andrew S. Boutros, *Treating Medical Malpractice Claims Under A Variant of the Business Judgment Rule*, 77 Notr. D. L. Rev. 373, 374-83 (2002). Two recent works, while

malpractice reform debate.

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purporting to rebut criticisms of medical malpractice law, nonetheless acknowledge its inadequacies in proposing substantial reforms, in the first instance even proposing a variant of early offers to reduce exposure to pain and suffering damages. See David A. Hyman and Charles Silver, *The Poor State of Heath Care Quality in the U.S.: Is Malpractice Liability Part of the Problem or Part of the Solution?* 90 CORNELL L. REV. 893, 986-87, 992 (2005); TOM BAKER, THE MEDICAL MALPRACTICE MYTH 90, 163-64; 172-74 (2005).

i. Many observers view the current system of tort liability for personal injury as unworkable and in need of fundamental reform. Under the current system, a claimant must prove two difficult elements: the defendant's fault, and the financial value of noneconomic damages, mostly for pain and suffering. In medical malpractice cases, determining fault is often especially complex, given the intricacies of medical decision contexts and the probabilistic consequences of medical interventions and their interaction with underlying patient characteristics. As a result, the system is subject to uncertainties that allow many injured patients to receive little or nothing while comparably injured others are paid much more than their economic losses. One earlier finding indicated that only 28 cents of the medical malpractice premium reaches claimants, and of that, only 12.5 cents goes to compensate for the actual expenses incurred by patients, with the rest going to legal fees, insurance overhead, and the like.[2] As pointed out, all this uncertainty generates not only substantial transaction costs (mostly legal fees on both sides) but long delays in any payment that is made, usually measured in years. In the end, the liability insurance system does not result in prompt payment to many needy victims; rather, it is a system of prolonged, unpredictable, expensive fights over whether claimants are deserving and/or what payment they deserve -- a system that often operates to the detriment of both health care professionals and injured patients, especially seriously injured patients.

ii. The present system of tort liability insurance for medical injuries may lead to the anomalous result of providing the least protection to those who need it most: seriously injured parties whose medical expenses and wage losses exceed any applicable private or public insurance coverage. The present legal system in effect tells patients that they may be paid something, but only years from

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[2] Jeffrey O=Connell, *An Alternative to Abandoning Tort Liability* 60 MINN. L. R. 501 506-09 (1976).

now and only after paying out or any recovery lawyer's fees of 30 percent or higher.

The tort system imposes far fewer risks on the various medical malpractice liability participants who are not seriously injured victims. Health care providers typically have protection through their liability insurance coverage, and their insurers are protected by their risk-spreading, strengthened by actuarial calculations. Defense lawyers are paid, win or lose. Claimants' lawyers have little incentive to take a case unless they are confident it is likely to lead to an expected payment in excess of their expenses and opportunity costs. Even if the risk of nonpayment for any given claim is high, the claimants' lawyer can minimize this risk by taking multiple cases to assure portfolio diversification, a form of protection denied to the seriously injured victim, who normally will have only one such claim in a lifetime. Finally, the less seriously injured are relatively protected by the very fact of their lesser losses which may, in turn, be covered by their own health insurance or sick leave.

iii. The early offer reform addresses the main shortcomings of the current system. Before considering the benefits of early offers, it is useful to review their structure. Under such an approach, a defendant has the option (not the obligation) to offer an injured patient, within 180 days after a claim is filed, periodic payment of the claimant's net economic losses as they accrue. Economic losses under an early offer statute must cover medical expenses, including rehabilitation plus lost wages, to the extent that all such costs are not already covered by other insurance ("collateral sources"), plus an additional 10 percent attorney's fee. Therefore, a defendant cannot make a lesser or "low ball" offer and still be covered by the statute. Nor is there any need for a court to determine

whether the early offer is fair. The early offer statute defines the fairness of the offer, similar to a workers' compensation statute for workplace accidents.

If an early offer is made and accepted, that, of course, settles the claim. If the defendant decides not to make an early offer, the injured patient can proceed with a normal tort claim for medical expense and wage loss plus pain and suffering. Alternatively, if the claimant declines an early offer in favor of litigation, (1) the standard of proof of misconduct is raised, allowing payment only where "gross negligence" is proven; and (2) the standard of proof is also raised, requiring proof of such misconduct beyond a reasonable doubt (or at least by clear and convincing evidence).

iv. Consider a typical case to illustrate how the early offer law would work. A patient has been injured in the course of treatment. If the patient wins in court, she would be awarded $1 million, but given the risks of litigation, she has only a 50 percent chance of winning. Roughly calculated, the patient has a claim worth about $500,000 (50 percent chance at $1 million). Assume the cost of setting aside a corpus of money to pay the patient's net economic losses as they accrue is projected at about $250,000 (an often realistic assumption in such a case, as studies demonstrate). The health care provider's insurer would likely make the early offer, $250,000 being clearly less than $500,000. And the patient would likely accept, given that under the early offer proposal the plaintiff will have the normally insuperable burden of proving her doctor guilty of gross negligence beyond a reasonable doubt.

Now assume a change in the facts: same patient, same health care provider, and the same possible $1 million verdict. But here assume this patient's chances of winning are only one in ten, with an expected value of $100,000 (1/10 of $1 million). Here the defendant's insurer would not make an early offer, $100,000 being clearly less than $250,000.

v. The fear of potentially higher costs to insurers under this early offer scheme is avoided because no defendants need make an offer if they would not do so without this statute. Thus, defendants will make an offer only when it makes economic sense for them to do so, as shown in the example above.

vi. But won't insurance companies thereby just "cherry pick" claims by making lower payments to clearly deserving claimants? Because of the uncertainty and cost of determining both liability and pain and suffering damages under present tort law, it is likely, as indicated in Item iv above and the report itself below, that defendants in medical malpractice cases will make prompt early offers in many cases even when liability is unclear.

vii. The proposal would affect injury victims in many ways that are advantageous. While injury victims would lose their recourse to full-scale tort litigation, they would reduce their uncertainty, delays, and transaction costs. Moreover, they would lose their current tort litigation recourse only when they are guaranteed prompt payment of their actual economic losses plus attorney's fees. These prompt and certain payments will be especially advantageous to those seriously injured patients whose losses have outstripped other applicable coverage.

viii. Several factors make it unattractive for early offers to be made voluntarily without an early offer statute. Defendants today may be confident of defeating or at least wearing down claimants, given the difficulties and delays in proving a tort claim. The long delay before trial may often enable defendants to bargain down even claimants clearly entitled to tort damages because the latter may need immediate money for accrued and accruing medical bills and wage loss. Furthermore, defendants may fear that an early offer to settle for claimants' net economic loss will be seen as a signal of weakness and encourage claimants and their lawyers to seek an even larger

settlement than originally sought. This mirrors the position of claimants and their lawyers, who similarly fear that an early offer to settle only for economic loss would be deemed an admission of weakness in their cases, resulting in either no payment or less than that otherwise sought.

ix. Early offers will be a viable mechanism only if defendants, not claimants, are allowed to make binding early offers. Claimants and their counsel would lack sufficient incentives to weed out frivolous or non-meritorious claims if they had the power to unilaterally bind defendants by their claims. This would result in a perverse incentive to exploit the system with marginal claims or worse which would nonetheless be binding on defendants. But defendants, as the parties making payment, when confronted with clearly meritless or very marginal claims will pay nothing and make no early offer, as shown in the example above. On the other hand, when faced with potentially meritorious claims, defendants will have an incentive to explore whether the statutorily-defined early offer involves less expected cost than a full-scale tort suit with all its uncertainty and transaction costs. Thus, only defendants have the appropriate incentives to distinguish carefully between arguably meritorious and clearly non-meritorious claims in order to reduce costs by promptly paying the required minimum benefits in suitable cases.

x. There are also several rationales for why damages for pain and suffering are not included in the early offer reform. The uncertainty of determining both liability and damages for noneconomic damages is the key to understanding the inefficiencies of tort law and to framing a balanced solution that attempts to be fair to both injured patients and health care providers. Pain and suffering damages are indeterminate and highly volatile. Under an early offer system, the prospect of an award of pain and suffering damages nonetheless still serves as a means of internalizing health care

providers' medical mishaps by providing an incentive to make early offers covering injured patients essential economic losses. These offers thus will provide prompt compensation to many victims of injuries that accompany the delivery of medical services. In effect, the threat of paying damages for pain and suffering, rather than the actual payments, will better serve injured patients as well as the public interest.

Pain and suffering damages also differ from economic damages from the standpoint of insurance.[3] Because accidents and illnesses generally reduce the marginal utility of income, people do not generally find it desirable to purchase pain and suffering insurance. Indeed, no such general insurance market has emerged. In contrast, risk-averse individuals will desire full insurance of their economic losses, which is the focal point of the early offer proposal.

Because personal injury claims alone among all other damage claims routinely entail damages for both economic and noneconomic losses, defendants are uniquely positioned not only to make, but also to enforce by early offers, socially attractive settlements for only economic loss. In non-personal injury claims, where only economic damages are at stake, no comparably fair means are available to sanction a claimant who refuses to accept an offer of only a portion of the total losses claimed.

xi. A complete no-fault plan for medical injuries does not seem feasible. It is difficult to define in advance when no-fault benefits should be paid for injuries that arise from medical treatment. Under no-fault auto insurance policies, an accident victim is compensated for an injury "arising out of the ownership, maintenance, or use of a motor vehicle." Under workers'

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[3] See W. Kip Viscusi, *Pain and Suffering: Damages in Search of a Sounder Rationale*, I MICHIGAN LAW AND POLICY REV 141 (1996).

compensation laws, an industrial accident victim is compensated for an "injury arising out of, and in the course of, employment." It is not feasible, however, to force all health care providers to pay patients for any and all adverse events arising in the course of medical treatment. It is often impossible to determine whether a patient was injured by the treatment rendered, or whether the adverse condition after treatment was just a normal extension of the condition which prompted treatment in the first place. A health care provider could not be expected to pay every patient whose condition worsens after treatment. Thus such a comprehensive *ex ante* no-fault solution is unworkable, and therefore unavailable. The proposed early offer system for medical accidental injuries enables, when the facts are much better known, *ex post* comparisons of the cost of a tort claim versus that of an early offer, and so this system seems a uniquely workable, economical, equitable, and simplifying solution.

Some operational features of the early offer plan

It may be useful, for example, to address some questions regarding the time frame for operation of the early offer plan. Is the 180-day period too short a time for the defendant to decide to make an early offer? In general, insurers already compute their initial reserve amounts in a much shorter period, and the preliminary discovery process would be accelerated by the early offer structure. In addition to doing research to decide whether to bring a claim, claimants and their lawyers can also take their time and press any discovery they deem necessary before responding to any early offer.

Court approval of the terms of an accepted early offer will no more be required than is court approval of the terms of a workers' compensation case. Of course, there may be later disputes after

an early offer settlement regarding what is due periodically as losses accrue in the future, but that can happen under workers= compensation or any major medical/disability policy extending into the future. Courts now routinely review settlements in minors' cases, a practice that presumably will continue.

An early offer settlement is no worse than lump sum court awards in dealing with seemingly difficult questions, such as whether the claimant's condition might change. The parties also might agree to a structured settlement,. *i.e.,* present estimates which would bypass the need for future recalculations of amounts as they are due. In the case of death, the survivors would be due the amount, if any, that the decedent's earnings would have been expected to provide as support. Note that the Michigan no-fault auto law with its large wage loss coverage extending to the hundreds of thousands of dollars has been able to deal effectively with such matters.

As to the limit on claimant attorneys' fees to 10 percent of the value of the early offer, this percentage is based on a comparison of (1) the current almost uniform minimum of one-third of the value of a full-scale tort settlement or verdict and (2) the claimant's attorney fees under no-fault workers' compensation, which are not uncommonly limited to 10 percent for losses above a minimum payment.

Note further that by definition there will be no trial expenses under early settlements. Note too that the early settlement will also greatly diminish pre-trial expenses. Also, if the 10 percent fee is manifestly too low because of special circumstances, claimant's counsel can petition the court for an augmentation that will be payable by the early offerer.

When an early offer makes sense, all the insurers involved in the case, should join together in making the early offer. If not, insurers not making an early offer would be left with a claimant now

pursuing economic damages with no offset for collateral sources, plus non-economic damages. Indeed such a case would be financed by payment from any other insurer's early offer. As a practical matter disputes over division of the ultimate cost to any given insurer would be handled later through arbitration.

Conclusion

An economic model of the cost and other effects of the early offer proposal shows a typical result as follows: With the parties stalemated after years of negotiation between $279,000 and $408,000, an early offer of $190,740 covering claimant's net economic loss, plus 10% for claimant's attorney's fee, would have netted claimant $173,400 and settled the case promptly.

The model especially highlights the "wedge" effect, that current law induces in placing barriers between claimants and defendants, greatly inhibiting efficient settlements B a wedge that early offers greatly diminish.

> A Wedge Effect . . . exists when buyers and sellers in a market must share a cost related to consummating a transaction. The Wedge is the amount by which the purchase price to the buyer is raised plus the amount the selling price received by the seller is reduced. The paradigmatic example is the sales tax on goods. To the extent that litigation-based costs cause a Wedge Effect in the market for resolution of medical malpractice claims, the current [tort] system artificially prevents some welfare-enhancing settlements, reduces the compensation of claimants unnecessarily,

inflates the payment of defendants and creates a deadweight loss.[4]

The early offer reform should lead to cost savings and speedy resolution of many cases if adopted. The main benefit to claimants of the early offer reform is that if an offer is made and accepted, claimants receive assurance of payment that covers their net economic losses approximately six months after the claim is filed. Payment will thus be received much sooner than under the current system and with much lower transaction costs.

The disadvantage to the claimant of accepting the early offer is that the possibility of receiving noneconomic damages is eliminated. Since noneconomic damages often involve greater sums than economic damages, this loss is admittedly significant. But only in about 3 percent of present cases does the possibility of punitive plus noneconomic damages exist. Under an early offer regime even in such cases victory would not be assured since the burden of proof would be substantially greater than it is now.

Although, the extent to which savings from early offers would be passed on through lower malpractice insurance premiums is unknown, assuming a competitive marketplace, one certainly can expect that to happen.

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[4] Jeffrey O=Connell, Jeremy Kidd, & Evan Stevenson, An Economic Model Costing AEarly Offers@ Medical Malpractice Reform, 35 N. Mex. L. Rev. 259, 280.